

FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended October 3, 1998

OR

[] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 0-19621

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

MINNESOTA
(State or other jurisdiction of incorporation or organization) 41-1454591
7400 Excelsior Blvd. (I.R.S. Employer Identification No.)
Minneapolis, Minnesota 55426-4517
(Address of principal executive offices)

(612) 930-9000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

YES NO

As of November 13, 1998, the number of shares outstanding of the registrant's no par value common stock was 1,236,744 shares.

APPLIANCE RECYCLING CENTERS of AMERICA, INC.

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Appliance Recycling Centers of America, Inc. and Subsidiaries
CONSOLIDATED BALANCE SHEETS
(Unaudited)

<TABLE>
<CAPTION>

October 3,
1998

January 3,
1998

<S>	<C>	<C>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 696,000	\$ 13,000
Accounts receivable, net of allowance of \$75,000 and \$35,000, respectively	1,170,000	736,000
Inventories	1,937,000	694,000
Other current assets	135,000	140,000
Refundable income taxes	--	29,000
Total current assets	\$ 3,938,000	\$ 1,612,000
Property and Equipment, at cost		
Land	\$ 2,103,000	\$ 2,103,000
Buildings and improvements	4,156,000	3,955,000
Equipment	3,718,000	5,461,000
Less accumulated depreciation	\$ 9,977,000	\$ 11,519,000
Net property and equipment	\$ 5,907,000	\$ 6,712,000
Other Assets		
Goodwill, net	\$ 335,000	\$ 55,000
	162,000	190,000
Total assets	\$ 10,342,000	\$ 8,569,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit	\$ 526,000	\$ 1,513,000
Current maturities of long-term obligations	107,000	101,000
Accounts payable	1,808,000	1,136,000
Accrued expenses	789,000	821,000
Total current liabilities	\$ 3,230,000	\$ 3,571,000
Long-Term Obligations, less current maturities	4,955,000	1,633,000
Total liabilities	\$ 8,185,000	\$ 5,204,000
Shareholders' Equity		
Common stock, no par value; authorized 10,000,000 shares; issued and outstanding 1,237,000 shares as of October 3, 1998 and 1,137,000 shares as of January 3, 1998	\$ 10,857,000	\$ 10,350,000
Accumulated deficit	(8,700,000)	(6,985,000)
Total shareholders' equity	\$ 2,157,000	\$ 3,365,000
Total liabilities and shareholders' equity	\$ 10,342,000	\$ 8,569,000

</TABLE>

See Notes to Consolidated Financial Statements.

Appliance Recycling Centers of America, Inc. and Subsidiaries
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

<S>	Three Months Ended		Nine Months Ended	
<C>	October 3,	September 27,	October 3,	<C>
	1998	1997	1998	
September 27, 1997				
Revenues				
Retail revenues	\$ 2,170,000	\$ 1,047,000	\$ 5,638,000	\$
3,013,000				
Recycling revenues	1,846,000	1,411,000	4,013,000	
4,881,000				
Byproduct revenues	238,000	331,000	828,000	
1,134,000				
Total revenues	\$ 4,254,000	\$ 2,789,000	\$ 10,479,000	\$
9,028,000				
Cost of Revenues	2,529,000	1,716,000	6,944,000	
5,077,000				

Gross profit	\$ 1,725,000	\$ 1,073,000	\$ 3,535,000	\$
3,951,000				
Selling, General and Administrative Expenses	1,602,000	1,175,000	4,567,000	
3,842,000				
Loss on Impaired Assets	--	--	518,000	
--				

Operating income (loss)	\$ 123,000	\$ (102,000)	\$ (1,550,000)	\$
109,000				
Other Income (Expense)				
Other income	8,000	(1,000)	277,000	
118,000				
Interest income	--	4,000	1,000	
8,000				
Interest expense	(182,000)	(82,000)	(412,000)	
(255,000)				

Income (loss) before provision for income taxes and minority interest	\$ (51,000)	\$ (181,000)	\$ (1,684,000)	\$
(20,000)				
Provision for (Benefit of) Income Taxes	30,000	(2,000)	31,000	
(31,000)				

Income (loss) before minority interest	\$ (81,000)	\$ (179,000)	\$ (1,715,000)	\$
11,000				
Minority Interest in Net Income of Subsidiary	--	31,000	--	
85,000				

Net income (loss)	\$ (81,000)	\$ (210,000)	\$ (1,715,000)	\$
(74,000)				
=====				
Basic and Diluted Earnings (Loss) per Common Share	\$ (0.07)	\$ (0.18)	\$ (1.44)	\$
(0.07)				
=====				
Weighted Average Number of Common Shares	1,237,000	1,137,000	1,187,000	
1,137,000				
=====				

</TABLE>

See Notes to Consolidated Financial Statements.

Appliance Recycling Centers of America, Inc. and Subsidiaries
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

<TABLE>
<CAPTION>

	Nine Months Ended	
	October 3, 1998	September 27, 1997
<S>	<C>	<C>
Cash Flows from Operating Activities		
Net income (loss)	\$ (1,715,000)	\$ (74,000)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	587,000	814,000
Minority interest in subsidiary	--	85,000
Loss on impaired assets	518,000	--
(Gain) loss on sale of equipment	(232,000)	(66,000)
Change in assets and liabilities:		
(Increase) decrease in:		
Receivables	(434,000)	129,000
Inventories	(1,243,000)	(16,000)
Other current assets	5,000	56,000
Refundable income taxes	29,000	371,000
Increase (decrease) in:		
Accounts payable	672,000	(469,000)
Accrued expenses	(32,000)	(419,000)

Net cash provided by (used in) operating activities	\$ (1,845,000)	\$ 411,000

Cash Flows from Investing Activities		
Purchase of property and equipment	\$ (270,000)	\$ (204,000)
Proceeds from disposal of property and equipment	237,000	86,000

Net cash used in investing activities	\$ (33,000)	\$ (118,000)

Cash Flows from Financing Activities		
Decrease in line of credit	\$ (987,000)	\$ (299,000)
Payments on long-term obligations	(389,000)	(172,000)
Proceeds from sale of common stock	200,000	--
Proceeds from long-term debt obligations	3,718,000	--
Proceeds ascribed to warrants issued in conjunction with long-term debt	307,000	--
Fees from financing activities	(288,000)	--

Net cash provided by (used in) financing activities	\$ 2,561,000	\$ (471,000)

Increase (decrease) in cash and cash equivalents	\$ 683,000	\$ (178,000)
Cash and Cash Equivalents		
Beginning	13,000	280,000

Ending	\$ 696,000	\$ 102,000

Supplemental Disclosures of Cash Flow Information		
Cash payments (receipts) for:		
Interest	\$ 414,000	\$ 255,000
Income taxes net of refunds	\$ 1,000	\$ (400,000)
=====		

</TABLE>

See Notes to Consolidated Financial Statements.

Appliance Recycling Centers of America, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Financial Statements

In the opinion of management of the Company, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal, recurring accruals) necessary to present fairly the financial position of the Company and its subsidiaries as of October 3, 1998, and the results of operations for the three-month and nine-month periods and its cash flows for the nine-month periods ended October 3, 1998 and September 27, 1997. The results of operations for any interim period are not necessarily indicative of the results for the year. These interim consolidated financial statements should be read in conjunction with the Company's annual financial statements and related notes in the Company's Annual Report on Form 10-K for the year ended January 3, 1998.

2. Accrued Expenses Accrued expenses were as follows:

	October 3, 1998	January 3, 1998
	-----	-----
Compensation	\$220,000	\$167,000
Lease contingencies and closing costs	110,000	289,000
Other	459,000	365,000
	-----	-----
	\$789,000	\$821,000
	=====	=====

3. Preferred Stock

In April 1998, the Company's shareholders approved an amendment to the Company's Articles of Incorporation authorizing two million shares of Preferred Stock of the Company ("Preferred Stock") which may be issued from time to time in one or more series having such rights, powers, preferences and designations as the Board of Directors may determine.

4. Loss On Impaired Assets

During the three months ended July 4, 1998, the Company elected to curtail its appliance shredding operation and intensify its strategic focus on appliance retailing. As a result, the Company recorded \$518,000 as a loss on impaired assets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued

5. Whirlpool Agreement

On July 8, 1998, the Company entered into an agreement with Whirlpool Corporation for the acquisition of distressed appliances ("Whirlpool Agreement"). Under the Whirlpool Agreement, the Company has the exclusive right and has the obligation to purchase from Whirlpool all Whirlpool distressed appliances in the Midwest and certain western states. Under the Whirlpool Agreement, the Company must purchase up to \$3,000,000 of distressed appliances in any three-month period, with certain exceptions. The Whirlpool Agreement may be terminated by either party upon 180 days' written notice, however, it is not terminable by Whirlpool before July 8, 1999 except for cause. Cause is defined in the Whirlpool Agreement to include (i) the Company's breach of the Whirlpool Agreement, (ii) the Company's misappropriation of Whirlpool funds, (iii) the Company ceases to exist as a going concern, or (iv) the Company uses Whirlpool trademarks without the written consent of Whirlpool. In addition, the Company has agreed to indemnify Whirlpool for certain claims, allegations or losses with respect to Whirlpool appliances sold by the Company. The Agreement is expected to supply the Company's Encore(R) and Appliance\$mart(SM) retail outlets with a significant supply of Whirlpool appliances.

PART I: ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis provides information that management believes is relevant to an assessment and understanding of the Company's level of operations and financial condition. This discussion should be read with the consolidated financial statements appearing in Item 1.

RESULTS OF OPERATIONS

The Company generates revenues from three sources: retail revenues, recycling revenues and byproduct revenues. Retail revenues are sales of appliances, extended warranty sales and delivery fees. Recycling revenues are fees charged for the disposal of appliances. Byproduct revenues are sales of materials generated from processed appliances.

Total revenues for the three and nine months ended October 3, 1998 were \$4,254,000 and \$10,479,000, respectively, compared to \$2,789,000 and \$9,028,000 for the same periods in the prior year.

Retail revenues for the three and nine months ended October 3, 1998 increased by \$1,123,000 or 107.3% and \$2,625,000 or 87.1%, respectively, from the same periods in the prior year. Third quarter same-store retail sales increased 138% (a sales comparison of 10 stores that were open the entire third quarters of 1998 and 1997). Retail sales accounted for approximately 51% of revenues in the third quarter of 1998. The increase in retail sales was primarily due to increased sales of Whirlpool product.

In July 1998, the Company announced that it had entered into a contract with Whirlpool Corporation to acquire its distressed appliances (including "scratch and dent" units with only cosmetic imperfections) from distribution centers serving the Midwest and certain western states.

Currently, the Company has 11 retail locations. The Company plans to continue focusing on increasing sales in the geographic areas where it is currently located. It plans to consolidate certain of its existing stores and open an additional three to five new stores over the next 12 months. The Company experiences seasonal fluctuations and expects retail sales to be higher in the second and third calendar quarters than in the first and fourth calendar quarters, reflecting consumer purchasing cycles.

RESULTS OF OPERATIONS - continued

Recycling revenues increased for the three months ended October 3, 1998 by \$435,000 or 30.8% and decreased for the nine months ended October 3, 1998 by \$868,000 or 17.8% as compared to the same periods in the prior year. The increase in recycling revenues in the third quarter of 1998 was primarily due to the increase in refrigerator recycling volume related to the contract with Southern California Edison Company ("Edison"). The decrease in recycling revenues for the nine months ended October 3, 1998 was primarily due to lower contract volume of appliances than in the previous year. The contract with Edison, which ended September 30, 1998, has generated \$3.0 million in revenues in 1998. At this time, no definitive contract has been entered into for the fourth quarter of 1998. However, Edison has indicated its intention to extend

its refrigerator recycling program through December 1998. Also, no definitive contract has been entered into for 1999. Edison is expected to file its proposed program for 1999 with the California Public Utilities Commission in mid-November 1998.

Byproduct revenues for the three and nine months ended October 3, 1998 decreased by \$93,000 or 28.1% and \$306,000 or 27.0%, respectively, from the same periods in the prior year. The decrease was primarily due to lower sales of reclaimed chlorofluorocarbons due to fewer refrigerators being recycled and lower scrap revenue due to a decrease in scrap prices.

Gross profit as a percentage of total revenues for the three months ended October 3, 1998 increased to 40.6% from 38.5% and decreased to 33.7% from 43.8% for the nine months ended October 3, 1998. The increase in the third quarter of 1998 was primarily due to an increase in recycling revenues related to the Edison contract. The decrease in gross profit as a percentage of total revenues for the nine months ended October 3, 1998 was primarily due to retail revenues, which have a lower gross profit than recycling revenues, being a higher percentage of total revenues. Gross profit as a percentage of total revenues for future periods can be affected favorably or unfavorably by numerous factors, including the volume of appliances recycled from the Edison contract, the volume of Whirlpool product sold during the period and the price and volume of byproduct revenues. The Company expects margins to continue to decline as retail revenues become a higher percentage of total revenues.

RESULTS OF OPERATIONS - continued

Selling, general and administrative expenses for the three and nine months ended October 3, 1998 increased by \$427,000 or 36.3% and \$725,000 or 18.9%, respectively, from the same periods in 1997. Selling expenses for the three and nine months ended October 3, 1998 increased by \$148,000 or 41.5% and \$357,000 or 32.8%, respectively, from the same periods in 1997. The increase in selling expenses for the third quarter of 1998 compared to 1997 was primarily due to an increase in advertising for the retail stores and an increase in sales commissions. The increase in selling expenses for the nine months ended October 3, 1998 was primarily due to an increase in costs associated with opening an additional retail store during the first quarter of 1998, an increase in sales commissions and an increase in advertising during the first nine months of 1998. General and administrative expenses for the three and nine months ended October 3, 1998 increased by \$279,000 or 34.1% and \$368,000 or 13.4%, respectively, from the same periods in 1997. The increase in general and administrative expenses was primarily due to increased expenses related to personnel costs.

The Company took a one-time charge of \$518,000 during the three months ended July 4, 1998 related to a loss on impaired assets associated with the Company's decision to curtail the appliance shredding operation of its recycling business located primarily at the Company's Minneapolis center.

Interest expense for the three and nine months ended October 3, 1998 increased by \$100,000 or 122.0% and \$157,000 or 61.6%, respectively, from the same periods in 1997. The increase in interest expense was due to a higher average borrowed amount for the three and nine months ended October 3, 1998 than in the same periods in 1997.

The Company recorded a provision for income taxes for the nine months ended October 3, 1998 of \$31,000. The Company recorded a benefit of income taxes of \$31,000 and a related receivable of \$29,000 for the nine months ended September 27, 1997 due to the liquidation of its Canadian subsidiary. The income taxes receivable became unrealizable during the third quarter of 1998 upon the liquidation of its Canadian subsidiary. The Company also has available net operating loss carryforwards that total approximately \$7,344,000 which expire in the years 2011 through 2013. At October 3, 1998, the Company had a valuation allowance recorded against its net deferred tax assets of approximately \$3,632,000, due to uncertainty of realization. Realization of deferred tax assets is dependent upon the generation of sufficient future taxable income during the period that deductible temporary differences and carryforwards are expected to become available to reduce taxable income.

RESULTS OF OPERATIONS - continued

During the fourth quarter of 1997, the Company purchased all the minority shareholder's stock in ARCA California, Inc., a subsidiary of the Company. Prior to that time, the California subsidiary was owned 80% by the Company and 20% by a minority shareholder. Accordingly, a minority interest was recorded for the three and nine months ended September 27, 1997, of \$31,000 and \$85,000, respectively.

The Company recorded a net loss of \$81,000 (or \$.07 per share) for the three months and \$1,715,000 (or \$1.44 per share) for the nine months ended October 3, 1998, compared to a net loss of \$210,000 (or \$.18 per share) and \$74,000 (or \$.07 per share) in the same periods of 1997. The decrease in income was primarily due to the one-time charge and higher operating and selling, general and administrative expenses offset by higher retail sales, as discussed above.

LIQUIDITY AND CAPITAL RESOURCES

At October 3, 1998, the Company had a working capital surplus of \$708,000 compared to a working capital deficit of \$1,959,000 at January 3, 1998. Cash and cash equivalents increased to \$696,000 at October 3, 1998 from \$13,000 at January 3, 1998. Net cash used in operating activities was \$1,845,000 for the nine months ended October 3, 1998 compared to net cash provided by operating activities of \$411,000 in the same period of 1997. The decrease in cash provided by operating activities was primarily due to the net loss for the period plus an increase in inventories, offset by an increase in accounts payable and the loss on impaired assets.

The Company's capital expenditures for the nine months ended October 3, 1998 and September 27, 1997 were approximately \$270,000 and \$204,000, respectively. The 1998 and 1997 capital expenditures were primarily related to building improvements.

As of October 3, 1998, the Company had a \$2.0 million line of credit with a lender. The interest rate as of October 3, 1998 was 13-1/4%. The amount of borrowings available under the line of credit is based on a formula using receivables and inventories. The line of credit has a stated maturity date of August 30, 1999 and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The line of credit is secured by receivables and inventories and is guaranteed by the President of the Company. The loan also requires that the Company meet certain financial covenants, provides payment penalties for noncompliance, limits the amount of other debt the Company can incur, limits the amount of spending on fixed assets and limits payments of dividends. At October 3, 1998, the Company's unused borrowing capacity was \$600,000.

LIQUIDITY AND CAPITAL RESOURCES - continued

On May 19, 1998, the Company sold in a private placement, 100,000 shares of Common Stock at a price of \$2.00 per share. The sale, which represents approximately 8% of the Common Stock outstanding after such sale, was made to an institutional investor. The proceeds were used for additional working capital.

In June 1998, the Company entered into a ten-year, 9.88% mortgage loan for \$250,000. The proceeds from the mortgage loan were used to remodel one of its retail stores.

In July 1998, the Company issued 12% subordinate promissory notes in the principal amount of \$275,000, plus warrants to purchase Common Stock. The notes were paid in September 1998 with proceeds of the September 1998 Loan (as defined below). The lenders also received an aggregate of 68,750 warrants to purchase the Company's Common Stock at \$2.25 per share. The loan proceeds were used to purchase inventory and provide additional working capital.

In September 1998, the Company announced that it had entered into a loan agreement with a lender resulting in gross proceeds of \$3.5 million ("September 1998 Loan"). The maturity date for the loan is September 30, 2005 and the annual interest rate is 13%. The loan is secured by all the Company's personal property and all of its real estate. The Company issued to the lender, in connection with the loan, a warrant to purchase 700,000 shares of Common Stock at \$2.50 per share, which price may be adjusted in certain circumstances. The Company also issued to the investment banker, in connection with the September 1998 Loan, a warrant to purchase 125,000 shares of Common Stock at \$2.50 per share and paid a placement fee of \$180,000. The Company used the proceeds to repay certain indebtedness (including approximately \$1,500,000 of outstanding indebtedness), to finance inventory and for other general corporate purposes.

The portion of the gross loan proceeds ascribed to the warrants issued in conjunction with debt was \$307,000.

The Company does not believe that it has any significant risk related to interest rate fluctuation since it has only fixed rate debt, except the line of credit.

As previously reported, effective September 8, 1998, the Company was

delisted from The Nasdaq SmallCap Market because it no longer complied with The Nasdaq Stock Market's listing requirements.

LIQUIDITY AND CAPITAL RESOURCES - continued

The Company believes, based on the anticipated revenues from the expected Edison contract, the anticipated sales per retail store and the anticipated gross profit, that its current cash balance, funds generated from operations, the current loan and its current line of credit will be sufficient to finance its operations and capital expenditures through December 1998. In addition to the above, the Company is currently investigating avenues to raise additional working capital and to secure an increased line of credit to finance its operations and capital expenditures through December 1999. However, if the Company is unable to raise sufficient additional working capital or if it cannot secure an increased line of credit, it may be unable to expand its retail operations on the currently anticipated schedule, if at all. The Company's total capital requirements will depend, among other things as discussed below, on the number of recycling centers operating and the number and size of retail stores operating during the fiscal year.

Currently, the Company has four centers and 11 stores in operation. If revenues are lower than anticipated or expenses are higher than anticipated or the line of credit cannot be increased, the Company may require higher levels of additional capital than is currently expected to finance operations. Sources of additional financing may include further debt financing or the sale of equity or other securities. There can be no assurance that such additional working capital or other sources of financing will be available or available on terms satisfactory to the Company or permitted by the Company's current lender.

YEAR 2000

Based on a recent assessment, the Company determined that it will be required to modify or replace significant portions of its software so that its computer systems will properly utilize dates beyond December 31, 1999. The Company presently believes that with modifications to existing software and conversions to new software, the Year 2000 Issue can be mitigated. However, if such modifications and conversions are not made, or are not completed in a timely manner, the Year 2000 Issue could have a material impact on the operations of the Company.

The Company will utilize both internal and external resources to replace and test computer software for Year 2000 modifications. The Company plans to complete the Year 2000 project no later than June 30, 1999. The costs of the project will be funded through operating cash flows. A portion of the costs will be incurred to purchase new software, which will be capitalized. The remaining portion of the cost will be expensed as incurred over the next year. The overall cost of the project is not expected to have a material effect on the results of operations.

YEAR 2000 - continued

The costs of the project and the date on which the Company plans to complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events including the continued availability of certain resources, third party modification plans and other factors. However, there can be no guarantee that these estimates will be achieved and actual results could differ materially from those plans. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer codes, and similar uncertainties.

FORWARD-LOOKING STATEMENTS

Statements regarding the Company's future operations, need for working capital, performance and results, and anticipated liquidity discussed herein are forward-looking and therefore are subject to certain risks and uncertainties, including those discussed herein among others. In addition, any forward-looking information regarding the operations of the Company will be affected by the ability of individual stores to meet planned revenue levels, the speed at which individual retail stores reach profitability, costs and expenses being realized at higher than expected levels, the continued ability to purchase product from Whirlpool at acceptable prices, the Company's ability to secure an adequate supply of used appliances for resale, the continued availability of the Company's current line of credit, the raising of additional working capital, the renewal of the contract with Edison for the fourth quarter of 1998 and in 1999 and the ability and timing of

Edison to deliver units under its expected contract with the Company.

PART II. OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

The Company was involved in certain legal proceedings arising from the cancellation of leases in connection with the closing of certain facilities. The Company has established a reserve for lease settlements and closing costs. (See Note 2 to the Consolidated Financial Statements.)

ITEM 2 - CHANGES IN SECURITIES AND USE OF PROCEEDS

In July 1998, the Company issued 12% subordinated promissory notes in the aggregate principal amount of \$275,000, which notes were repaid with the proceeds from the September 1998 Loan. The lenders under such notes received an aggregate of 68,750 warrants to purchase the Company's Common Stock at \$2.25 per share. Such warrants are exercisable for three years after July 1998. The securities were issued pursuant to section 4(2) of the Securities Act of 1933.

The Company entered into a loan agreement with Medallion Capital, Inc. ("Medallion") in connection with the September 1998 Loan discussed above. The Company issued to Medallion, in connection with the September 1998 Loan, a warrant to purchase 700,000 shares of Common Stock at \$2.50 per share, which price may be adjusted in certain circumstances. Such warrants may be exercised by Medallion prior to the latter of September 10, 1998 or two years after the repayment in full of the September 1998 Loan. Dougherty Summit Securities LLC acted as placement agent in relation to the September 1998 Loan. The Company paid the agent compensation including a placement agent fee of \$180,000 and warrants to purchase 125,000 shares of the Company's Common Stock at an exercise price of \$2.50 per share. In addition, the Company has agreed that for an 18-month period commencing September 9, 1998 that the Company may not complete any similar transaction or any equity transaction without first offering the agent a first right of refusal to participate in such transaction. The Company sold the securities pursuant to section 4(2) of the Securities Act of 1933.

ITEM 3 - DEFAULTS UPON SENIOR SECURITIES - None

ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS - None

ITEM 5 - OTHER INFORMATION

OTHER INFORMATION - continued

Shareholder Proposals:

Pursuant to the rules of the Securities and Exchange Commission ("SEC"), any shareholder wishing to have a proposal considered for inclusion in the Company's proxy solicitation material for the 1999 Annual Meeting of Shareholders must set forth such proposal in writing and file it with the Secretary of the Company no later than November 24, 1998. Pursuant to SEC Rule 14a-4(c)(1), any shareholder wishing to have a proposal considered at the 1999 Annual Meeting of Shareholders, but not submitted for inclusion in the Company's proxy solicitation material, must set forth such proposal in writing and file it with the Secretary of the Company no later than February 8, 1999 and failure to notify the Company by such date would allow the Company's proxies to use their discretionary voting authority when the proposal is raised at the Annual Meeting (to vote for or against the proposal) without any discussion of the matter in the proxy materials.

Other Events:

Effective September 8, 1998, the Company was delisted from The Nasdaq SmallCap Market. The Company cited the fact that it no longer complied with The Nasdaq Stock Market's continued listing requirements. In addition, the Company announced that it is continuing to pursue additional lines of credit.

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

- (a) (i) Exhibit 10.1 - Loan Agreement between Medallion Capital, Inc. and Appliance Recycling Centers of America, Inc. dated September 10, 1998.
- (ii) Exhibit 10.2 - Promissory note of the Company to Medallion Capital, Inc. in the principal amount of \$3,500,000 due September 30, 2005.

- (iii) Exhibit 10.3 - Security to agreement of the Company.
 - (iv) Exhibit 10.4 - Warrant of the Company in favor of Medallion Capital, Inc. for 700,000 shares of the Company's Common Stock.
 - (v) Exhibit No. 27 - Financial Data Schedule.
- (b) The Company filed a report on Form 8-K in September 1998 announcing that the Company was delisted from The Nasdaq SmallCap Market effective September 8, 1998.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Appliance Recycling Centers of America, Inc.
Registrant

Date: November 17, 1998

/s/Edward R. Cameron

Edward R. Cameron
President

Date: November 17, 1998

/s/Kent S. McCoy

Kent S. McCoy
Chief Financial Officer

LOAN AGREEMENT

BETWEEN

MEDALLION CAPITAL, INC.

AND

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

SEPTEMBER 10, 1998

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LOAN AGREEMENT

This Agreement is entered into September 10, 1998, between MEDALLION CAPITAL, INC., a Minnesota corporation, 7831 Glenroy Road, Suite 480, Minneapolis, Minnesota 55439-3132, a Licensee under the Small Business Investment Act of 1958 ("Lender"),

AND

APPLIANCE RECYCLING CENTERS OF AMERICA, INC., a Minnesota corporation, 7400 Excelsior Boulevard, Minneapolis, Minnesota, 55426 (the "Company").

THE PARTIES AGREE AS FOLLOWS:

ARTICLE ONE

THE INVESTMENT

1.1 LOAN.

The Company shall borrow from Lender a total of \$3,500,000 (the "Loan") under the terms described in this Agreement and the Note issued by the Company in the form attached as Exhibit 1.1.

1.2 SECURITY.

The Company's obligations under the Note, this Agreement, the Warrant and the Mortgages and Deed of Trust are secured pursuant to the Security Agreement attached as Exhibit 1.2. and the Mortgages and Deed of Trust attached as Exhibit 10.7

1.3 INTERCREDITOR AGREEMENT.

The Loan is also subject to the Intercreditor Agreement attached as Exhibit 1.3.

1.4 WARRANT.

Lender shall receive a Warrant (the "Warrant") to purchase 700,000 shares of the Company's common stock. The Warrant shall be exercisable beginning any time after the Loan closing at an exercise price of \$2.50 per share and shall terminate, if not exercised, upon the latter of the end of the seventh year or two years after the Loan is paid in full, all as more fully set forth in the Warrant attached as Exhibit 1.4.

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1.5 SECURITIES.

Unless specifically stated otherwise, any reference in this Agreement to "Security" or "Securities" shall include any and all of the Note, the Warrant and any security for which the foregoing are convertible, exchangeable or otherwise exercisable.

1.6 THE "INVESTMENT."

Any reference in this Agreement to the "Investment" shall refer to the purchase by Lender of Securities on the terms and conditions stated in this Agreement and to the Company's agreement to all of the terms and conditions. The Company acknowledges and agrees that if the Company is not as represented and warranted or will not comply with all of the Company's agreements that the Lender would not have made the Investment.

1.7 CLOSING.

This Agreement has been executed by the parties on September 10, 1998 (the "Closing" or "Closing Date").

1.8 FEES.

The Company shall pay an origination fee in the amount of \$70,000 and shall pay the drafting and legal expenses of Lender not to exceed \$5,000. The fees shall be paid at closing or when billed by Lender.

ARTICLE TWO

REPRESENTATIONS AND WARRANTIES

To induce the Lender to make the Investment in the Company, the Company makes

the representations and warranties set forth below. The Company acknowledges that these representations and warranties are a critical part of the Company Profile and are intended to form one of the primary bases of Lender's decision to make the Investment. Therefore, the Company has used great diligence to insure that all of the representations and warranties (and the information supplied pursuant thereto) are complete, accurate and not misleading in light of the circumstances surrounding the Investment and can be relied on by Lender in making the Investment. The parties agree that any representation or warranty which proves to be untrue, incomplete, or misleading in light of the circumstances, shall constitute a Default (as defined in Article Eight). The Company further acknowledges and agrees that if the Company is not as represented and warranted, the Lender would not make the Investment.

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The Company represents and warrants that:

2.1 GOOD STANDING.

The Company is a corporation duly organized, validly existing and in good standing under the laws of Minnesota, is authorized to engage in the business now carried on by it, and is qualified as a foreign corporation to do business in each state where the nature of the business done by it requires qualification, such states being those listed on 2.1 of the Disclosure Schedule attached as Exhibit 2.1.

2.2 CAPITAL STOCK.

The Company's authorized and outstanding capital and all outstanding options, warrants or other securities exercisable or exchangeable for capital stock are as described in 2.2 of the Disclosure Schedule.

2.3 SUBSIDIARIES.

The Company has the subsidiaries listed in 2.3 of the Disclosure Schedule. As used in this Agreement, "subsidiary" means any corporation, partnership, joint venture, limited liability company or other business entity in which the Company owns, directly or indirectly, shares of any class of equity or debt security.

2.4 FINANCIAL STATEMENTS.

The balance sheet and related statements of earnings and retained earnings for the periods ending December 31, 1997 and July 4, 1998, (the "Financial Statements") attached as Exhibit 2.4 present fairly the financial position of the Company as of their respective dates and the results of its operations for the periods indicated.

Except as otherwise disclosed in Exhibit 2.4, specifically included in the Financial Statements are amounts due to or from any officer, director, shareholder, or employee of the Company or any relative of the foregoing or any guarantees, pledges or other financial obligations of the Company to or from any officer, director, shareholder, or employee of the Company or any relative of the foregoing.

2.5 USE OF PROCEEDS.

The proceeds from the Securities shall be used only as described in the Sources and Uses Schedule attached as Exhibit 2.5.

2.6 ABSENCE OF MATERIAL CHANGES.

Since the date of the Financial Statements, except as described in 2.6 of the Disclosure Schedule, there have been no material adverse changes in the condition, financial or otherwise, of the Company or its business or properties, nor does the Company know of any which may occur; and since the date of the Financial Statements, except as described in 2.6 of the Disclosure Schedule, the Company has not issued, sold or acquired any of the outstanding shares of any class of its capital stock, nor are there any contingent obligations, liability for taxes or commitments not disclosed or subject to

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reserve in the Financial Statements of the Company other than transactions described in this Agreement.

2.7 SHAREHOLDERS, OFFICERS AND DIRECTORS.

Information furnished by the Company relative to the officers and directors of the Company (including the number of shares of any class of stock held by each), set forth in 2.7 of the Disclosure Schedule, is true and correct.

2.8 PROPERTY OWNERSHIP; LEASES.

The Company has good title, free and clear of all liens and encumbrances (other than liens for taxes not delinquent), except as indicated in the Financial Statements or Disclosure Schedule, to all real estate and assets reflected on the Financial Statements other than as disposed of in the ordinary course of

business since the date of the Financial Statements. All property or assets not owned by the Company and used in the operation of its business, if any, are subject to valid leases held by the Company covering their use or occupancy which leases are not in default. The Disclosure Schedule contains a list of all real estate owned or leased by the Company and all liens or encumbrances on the real estate or assets.

2.9 OWNERSHIP OF INTELLECTUAL PROPERTY RIGHTS.

The Company possesses all patents, licenses, trademarks, trademark rights, trade names, trade name rights, trade secrets, copyrights and the like ("Intellectual Property") necessary or appropriate to conduct its business as now conducted without conflict with those of any other person. All of the foregoing are listed in 2.9 of the Disclosure Schedule. Attached to the Disclosure Schedule is a listing of all licenses and/or royalty agreements and/or patent abstracts relating to any of the Intellectual Property held by the Company.

2.10 LITIGATION.

All of the litigation or proceedings pending, or to the knowledge of the Company or its principal officers, threatened against it or any of its properties in any court or by or before any governmental agency or arbitrator are listed in 2.10 of the Disclosure Schedule.

2.11 TAXES.

All Federal, State and other tax returns and reports of the Company required by law to be filed have been filed and all Federal, State and other taxes, assessments, fees and other governmental charges (other than those presently payable without penalty) imposed upon the Company or the properties, assets or payroll of the Company which are due and payable have been paid. All federal income tax returns for the prior two tax years are attached as Exhibit 2.11.

2.12 ABSENCE OF PROHIBITION OR LIENS.

There is no provision in the Company's current Articles of Incorporation or Bylaws, or, except as described in 2.12 of the Disclosure Schedule, in any indenture or agreement to which the Company is a party, nor any law, rule, regulations, contract, statute of any

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governmental authority, which limits or prohibits, or which may in the future limit or prohibit, the execution, delivery or fulfillment by the Company of this Agreement or its Exhibits or of any of the acts or agreements contemplated by this Agreement or by the Securities or which results or which may in the future result in the creation of a lien or encumbrance on any asset of the Company or on the Securities.

2.13 AUTHORIZATION.

The execution and delivery of this Agreement and of the Securities have been duly authorized by the Board of Directors of the Company and the officers of the Company are authorized to enter into this Agreement and take all steps necessary to carry out its terms. Certified copies of the authorizing resolutions are attached as Exhibit 2.13.

2.14 ABSENCE OF PUBLIC SALES.

Neither the Company nor any agent acting on its behalf has offered the Securities or any other security of the Company for sale, nor has it solicited offers to buy the Securities from any person or persons so as to bring the issuance or sale of the Securities within the provisions of Section 5 of the Securities Act of 1933, as amended, or the registration or qualification requirements of any state securities laws.

2.15 FINDER'S OR BROKER'S FEES.

All finder's fees, brokerage fees, or other expenses and fees due to any person as a result of the transactions in or contemplated by this agreement shall be paid solely by the Company.

2.16 SMALL BUSINESS CONCERN.

The Company is a "Small Business Concern" as that term is defined by the Small Business Administration. No officer or director or stockholder of the Company is, or has been within 6 months prior to the Closing Date, an officer, director, agent or employee of Lender or an "Associate", as that term is defined in Part 107 of Title 13 of the Code of Federal Regulations, of Lender. No portion of the proceeds derived from the sale of the Securities will be used for any purpose in contravention of any of the provisions of Part 107 of Title 13 of the Code of Federal Regulations. The Company has never been debarred from contracts with any governmental unit and no debarment proceedings are currently underway or threatened by any governmental unit.

2.17 CRIMINAL OFFENSES.

None of the officers or directors of the Company has been convicted of a felony within the past 10 years.

ARTICLE THREE

AFFIRMATIVE COVENANTS OF THE COMPANY

The Company acknowledges that the Lender would not have purchased the Securities except for the Company's promise to take certain actions, which promises were made to induce Lender to make the Investment. To the extent the Company fails to fully perform each and every one of the actions described below, the Company acknowledges that it increases Lender's risk beyond that contemplated or agreed to by the parties and constitutes a Default. In the event the Company is in Default on any of the Affirmative Covenants, it agrees to immediately notify Lender. Failure to so notify Lender shall be considered a Default in its own right.

3.1 PROMPT PAYMENT OF TAXES AND CLAIMS.

The Company shall pay when due all taxes, lawful claims for labor, materials, supplies, rents, lease payments and other debts and liabilities which if unpaid would by law be a lien or charge upon the property of the Company.

3.2 INSURANCE.

The Company shall maintain insurance policies in such types and amounts as are appropriate for its business. The policies in force on the Closing Date are listed in 3.2 of the Disclosure Schedule. In the event a policy lapses, is modified or replaced, the Company shall immediately notify Lender and send copies of the new policies.

3.3 REPAIRS.

The Company shall maintain in good repair and working order all assets used in its business.

3.4 BOARD OF DIRECTORS.

The Company's Board of Directors shall meet at least quarterly and consist of at least 3 people. The Company shall furnish Lender at least 15 days prior to any Board meeting written notice and an agenda of the meeting and shall provide Lender promptly a copy of the minutes of all meetings of the Board and all other actions and other reports of or given to the Board or any committee thereof. A representative of Lender shall have the right to attend all Board meetings and have the full rights of a Board member at the meeting except the right to vote on Board resolutions. The Company shall reimburse Lender (its employees or representatives) its actual out-of-pocket expenses for meetings with the Company.

3.5 DELIVERY OF FINANCIAL AND OTHER DOCUMENTS.

The Company shall deliver to Lender:

3.5.1 As soon as available and in any event within 120 days after the close of each fiscal year (a) a balance sheet of the Company as of the close of the fiscal year and consolidated statements of income and retained earnings and changes in financial position for the year then ended,

accompanied by an unqualified opinion of the Company's independent certified public accountants, acceptable to the Lender, and (b) a letter from such accountants stating whether the Company is in compliance with the provisions of Sections 4.2, 4.3, 4.4, 4.5, 4.10 and 4.11.

3.5.2 Within 10 days after the Company's issuance or receipt, copies of all reports submitted to the Company by its certified public accountants that contain an opinion rendered in connection with an examination of any financial statements of the Company; the preliminary prospectus and the effective prospectus contained in any registration statements filed with the Securities and Exchange Commission; any annual or periodic reports filed with the Commission; any listing application filed with any stock exchange; and each annual report and all other reports, including proxy solicitations, which the Company shall send to its shareholders.

3.5.3. Within 30 days after each monthly accounting period separate balance sheets of the Company and each of its subsidiaries as of the close of each month and statements of income and retained earnings for the portion of the fiscal year-to-date then ended, prepared in conformity with paragraph 3.6 and Lender's informational requirements. Upon request by Lender, a monthly aging report of the Company's accounts receivable and accounts payable, a copy of the reconciliation of the Financial Statements to the cash accounts, any off balance sheet

liabilities assumed by the Company, any capital expenditures in excess of \$10,000.

3.6 FORM OF FINANCIAL DOCUMENTS.
For purposes of this Agreement:

3.6.1 Except as provided in subsection 3.6.2, all financial statements of the Company provided under this Agreement shall be prepared in conformity with generally accepted accounting principles applied on a consistent basis.

3.6.2 If any accounting principle, method of valuation or governmental regulations followed in the preparation of financial statements is required to be modified by the Financial Accounting Standards Board, the Company shall so notify Lender, and the financial statements may be modified to such extent.

3.6.3 All fiscal year-end financial statements delivered to Lender shall be accompanied by a letter from the certified public accountant who prepared them stating that such statements have been prepared in compliance with the provisions of Section 3.6. All other financial statements and reports delivered to Lender pursuant to this Agreement shall be accompanied by a certificate signed by the Company's President, Treasurer or Chief Financial Officer, certifying that they have been prepared in compliance with the provisions of Section 3.6, that they fairly and accurately state the current financial condition of the Company, that the financial statements have been reconciled with the

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cash accounts, and that all payroll withholding taxes were paid when due, and that no event of Default existed during the accounting period covered by the financial statements. (A copy of the form of the certification is attached as Exhibit 3.6.3.) In the event the President, Treasurer or Chief Financial Officer cannot certify the above, a detailed disclosure of those items which cannot be certified together with a detailed explanation for each item shall be given to Lender, together with the financial statements. Disclosure of non-certified matters shall not cure any Default.

3.7 BUDGET.

At least 90 days prior to the Company's fiscal year end it shall begin developing a budget for the following fiscal year. At least 30 days prior to the close of each fiscal year, the Company's Board of Directors shall review the budget and the Board shall adopt an operating and capital expenditures budget for the next succeeding fiscal year. A copy of the budget with underlying assumptions shall be delivered to Lender not later than 10 days after approval by the Board.

3.8 INFORMATION ON REQUEST; DISCLOSURE.

The Company shall furnish promptly, at Lender's request, such information as may be reasonably necessary to determine whether the Company is in compliance with the terms of this Agreement or as may be needed by such Lender to prepare any required reports to shareholders or appropriate federal and state regulatory authorities. Lender shall keep the information confidential except that the Company consents to reasonable disclosure by Lender of the Company's information, including financial information, to the shareholders of Lender and appropriate federal and state regulatory authorities.

3.9 CORPORATE EXISTENCE.

The Company shall maintain its corporate existence and conduct its business in an orderly and regular manner.

3.10 LITIGATION.

The Company shall immediately notify Lender of all actual or threatened litigation and of all actual or threatened proceedings before any governmental or regulatory body to which it is a party and which may affect its business.

3.11 INSPECTIONS.

The Company shall permit, at such times as will not unreasonably interfere with the conduct of its business, Lender's representatives to visit and inspect any property of the Company and shall make available to the representatives for inspection or copying any of the Company's books and records. Each officer of the Company and the Company's independent accountants will discuss with any Lender's representatives any of the Company's affairs, finances and accounts at such times and as often as Lender may reasonably request.

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3.12 CORPORATE FUNDS.

Cash funds of the Company in excess of needs reasonably necessary for its day-to-day operations shall be used to purchase U.S. Treasury Bills or U.S. guaranteed securities or be deposited in bank or savings and loan association accounts or certificates of deposit.

3.13 CIVIL RIGHTS.

The Company shall comply with the provisions of the Civil Rights Acts of 1964 and file with or make available to Lender such information as may be necessary to enable Lender to meet its reporting requirements to the Small Business Administration.

ARTICLE FOUR

NEGATIVE COVENANTS OF THE COMPANY

The Company understands and agrees that there are certain business practices which increase the risk to Lender's investment. Therefore, to induce the Lender to make the investment, the Company agrees not to take certain actions. In the event the Company does take any of the actions forbidden below, the Company agrees that this materially changes the nature of Lender's investment and increases Lender's risk beyond that contemplated or agreed to by the parties and constitutes a substantial and major Default. In the event the Company violates any of the Negative Covenants, it agrees to notify Lender immediately. Failure to so notify Lender shall be considered a major Default in and of itself.

Therefore, so long as Lender holds any of the Securities, the Company shall not:

4.1 CHANGE OF OPERATIONS.

Substantially change the present nature of its business operations.

4.2 DIVIDENDS.

Directly or indirectly purchase, acquire, redeem or retire any shares of its capital stock outstanding nor pay any dividends except dividends paid by a subsidiary to the Company.

4.3 EXPENSE REIMBURSEMENT.

Cause or permit out-of-pocket expenses reimbursed to fail to meet the Internal Revenue Service test as a business expense deduction and will be reimbursed only upon submission of an expense report meeting the business expense documentation requirements of the Internal Revenue Service.

4.4 TRANSACTIONS WITH INSIDERS.

Purchase or sell any asset or service to or from a Company director or officer, or any person who owns or controls, directly or indirectly, 5% or more of the voting capital

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stock of the Company, or any relative of any of the foregoing, or any organization in which any one or more of the foregoing, together, hold, directly or indirectly, an ownership interest of 5% or more ("Affiliate"), or rent or lease property to or from an Affiliate, except with the prior written approval of Lender or except as set forth in 4.4 of the Disclosure Schedule.

4.5 APPLICATION OF FUNDS.

Invest in or otherwise divert any of its funds to an individual, other corporation or business entity, except to the Company or to a wholly-owned subsidiary of the Company, it being the intent of this Agreement that the Company and its subsidiaries will apply their full capital and resources to their own corporate business and purposes.

4.6 MERGER AND SUBSIDIARIES.

Except as set forth in 4.6 of the Disclosure Schedule, consolidate or merge with or purchase all or a substantial part of the assets of any other business or sell, lease or otherwise transfer any assets other than in the normal course of its present business or enter into any franchising agreements or create any subsidiaries.

4.7 GUARANTIES.

Guarantee or endorse any obligation of others, except obligations of its subsidiaries as may be appropriate for purposes of their obtaining usual and normal open account and short-term credit of the type normally and necessarily outstanding in the operation of the business, or otherwise assume any contingent liability.

4.8 INDEBTEDNESS.

Incur any indebtedness in addition to that existing or committed at the Closing Date except for usual and normal unsecured open account and short-term credit of the type normally and necessarily outstanding in the operation of the business,

other than as provided in Section 4.9.

4.9 ENCUMBRANCES; CONDITIONAL SALES.

Except for those encumbrances and liens disclosed in 4.9 of the Disclosure Schedule, create, incur, assume or suffer to exist any mortgage, pledge, lien or other encumbrance of any kind on any of its properties now owned or hereafter acquired, nor acquire or agree to acquire property under any conditional sales agreement or title retention contract, nor engage in any sale-and-leaseback transaction.

4.10 ACQUISITION OF FIXED ASSETS.

A summary of all purchases of fixed assets shall be presented to the Lender in conjunction with the monthly financial statements.

4.11 BUSINESS RELOCATION.

Move its corporate or business offices or make any other substantial change in the nature of the Company's business.

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4.12 CHANGE IN CONTROL.

Sell, lease, transfer or dispose of any of the Company's assets outside the ordinary course of business nor transfer any assets necessary for the continuation of the Company's business except as disclosed in 4.12 of the Disclosure Schedule.

4.13 AMEND ARTICLES.

Amend or change its Articles of Incorporation or By-Laws, or violate or breach any provisions thereof.

ARTICLE FIVE

SURVIVAL OF REPRESENTATIONS AND WARRANTIES

The Company understands and agrees that all its representations, warranties, covenants and agreements shall survive the execution and delivery of this Agreement and the Securities.

ARTICLE SIX

INVESTMENT REPRESENTATION: REGISTRATION AND

TRANSFER OF SECURITIES

6.1 INVESTMENT REPRESENTATION.

Lender represents that it is purchasing the Securities for the purpose of investment and not with a view to or for sale in connection with any distribution. Lender may sell the Securities only pursuant to the provisions of this Agreement and subject to applicable federal and state securities laws.

6.2 LEGEND.

Until the occurrence of one of the events specified in Section 6.11, the certificates representing the Securities shall bear the following legend:

THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933 (THE "1933 ACT") OR UNDER THE SECURITIES LAWS OF ANY STATE. THEY MAY NOT BE SOLD, TRANSFERRED OR OTHERWISE DISPOSED OF FOR VALUE EXCEPT PURSUANT TO REGISTRATION OR OPERATION OF LAW WITHOUT THE OPINION OF COUNSEL SATISFACTORY TO THE COMPANY THAT SUCH TRANSFER MAY LAWFULLY BE MADE WITHOUT REGISTRATION UNDER THE MINNESOTA SECURITIES

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LAWS, THE SECURITIES LAWS OF ANY OTHER STATE AND/OR THE 1933 ACT.

6.3 TRANSFERS.

Prior to any transfer of the Securities, Lender shall give the Company written notice of its intention to make the transfer, describing briefly the manner of the intended transfer. Promptly after receiving written notice, the Company shall present copies of the notice to counsel acceptable to Lender and the Company. If in the opinion of counsel the proposed transfer may be effected without registration of the Securities, the Company shall promptly notify Lender, and the Securities may be transferred in accordance with the terms of the notice. The Company shall not be required to effect any transfer prior to the receipt of a favorable opinion.

6.4 SIMULTANEOUS REGISTRATION.

If the Company takes action to register any of its securities under the Securities Act of 1933 or its successor ("1933 Act") other than any registration on Form S-4 or S-8 or any similar form that does not allow a registration of the type contemplated hereby, the Company shall give Lender written notice of its intention and use its best efforts to register the Common Stock issued or issuable upon exercise of the Warrant as Lender may specify by written notice to the Company within 20 days after Lender's receipt of the Company's notice. If, however, the offering to which the proposed registration statement relates is to be distributed by or through an underwriter selected by the Company, Lender shall agree either to sell its Common Stock issued or issuable upon exercise of the Warrant through the underwriter on the same terms and conditions as the Company or to withhold such Securities from the market for a period of 120 days (or such period as the underwriter requires) after the effective date of the registration statement. If the underwriter determines that the total number of the Company's securities and other securities proposed to be registered is more than can be accommodated without adversely affecting the offering, then the number of shares of Common Stock and other securities registered pursuant to this Section 6.4 on behalf of the Lender shall be reduced pro rata (by number of shares) to the number of shares offered by the Company such that the aggregate number is acceptable to the underwriter. As used in this Section and Section 6.5, the number of securities shall mean in the case of a convertible Note, the number of shares of Common Stock into which they may be converted. As used in this Article and Article Seven, registration under the 1933 Act shall include offerings made pursuant to the provisions of Regulation A under the 1933 Act.

6.5 SUBSEQUENT ONE-TIME REGISTRATION.

If after the initial registered public offering of any of the Company's securities, Lender requests the registration of its Common Stock issued or issuable upon exercise of the Warrant (other than those times specified in Section 6.4 but on not more than one occasion), the Company shall promptly thereafter (and consistent with the provisions of Section 6.4) use its best efforts to register all the Securities under the 1933 Act and in a manner corresponding to the methods of distribution described in Lender's request. If

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other of the Company's securities are to be included in any registration, the other securities shall be offered through underwriters selected by Lender, and acceptable to the Company. The Company shall not, however, without Lender's written consent, include under the registration statement or any other registration statement filed within 180 days after the effective date of the registration statement filed under this Section 6.5 any number of the shares of the Company's securities and other securities greater than the number the underwriter determines in its sole discretion will not adversely affect the offering. If the underwriter determines that the total number of Securities and other securities proposed to be registered is more than can be accommodated without adversely affecting the offering, then the number of other securities registered pursuant to this Section 6.5 shall be reduced pro rata (by number of shares) to the number of shares offered such that the aggregate number is acceptable to the underwriter.

6.6 ALTERNATIVE SUBSEQUENT REGISTRATION.

If at any time after 36 months from the Closing the Company has made any registered public offering of any of its securities, Lender requests the Company to register its Securities, other than as provided in Sections 6.4 and 6.5, the Company shall, as expeditiously as possible, and consistent with Sections 6.4 and 6.5, use its best efforts to register those Securities under the 1933 Act, in accordance with the methods of disposition described in the request. All expenses incurred in effecting any registration under this Section shall be paid by the Company.

6.7 REGISTRATION PROCEDURE.

When the Company is required by the provisions of this Article to use its best efforts to register Common Stock issued or issuable upon exercise of the Warrant under the 1933 Act, the Company shall, as expeditiously as possible:

6.7.1 Prepare and file with the Securities and Exchange Commission (the "Commission") a registration statement (including amendments and supplements) and otherwise comply with the provisions of the 1933 Act with respect to the Securities and use its best efforts to cause the registration statement to become and remain effective for the period, not to exceed 180 days, as may be necessary to effect the sale or other disposition of the Securities covered by the registration statement;

6.7.2 Before filing the registration statement, or prospectus or amendments or supplements, furnish Lender with copies of all documents proposed to be filed, which shall be subject to the approval of counsel designated by Lender;

6.7.3 Notify Lender promptly of the time when any registration statement or post effective amendment has become effective or any

supplement to any prospectus forming part of any registration statement has been filed;

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6.7.4 Notify Lender promptly of any stop order by the Commission suspending the effectiveness of any registration statement or of the initiation or threat of any proceeding for that purpose, and promptly use its best efforts to prevent the issuance of a stop order and to obtain the withdrawal of any stop order issued;

6.7.5 Use its best efforts to register or qualify the Securities covered by the registration statement under the securities or Blue Sky Laws of jurisdictions which Lender shall reasonably request and do any and all other acts and things as may be necessary or advisable to enable Lender to consummate the public sale or other disposition of the Securities; and

6.7.6 Furnish to Lender a signed counterpart, addressed to Lender, of: (a) an opinion of counsel for the Company, dated the effective date of the registration statement, and (b) a "comfort" letter signed by the Company's independent public accountants, covering substantially the same matters with respect to the registration statement (and the prospectus included therein) and, in the case of the accountants' letter, with respect to events subsequent to the date of the financial statement, as are customarily covered in opinions in connection with underwritten public offerings of securities.

6.8 COSTS OF REGISTRATION.

The costs and expenses of registration, including legal fees, special audit fees, printing expenses, filing fees and premiums for insurance, if any, incurred by the Company in connection with any registration made pursuant to this Article, shall be borne entirely by the Company.

6.9 INDEMNIFICATION OF LENDER.

In the event of any registration of the Common Stock issued or issuable upon exercise of the Warrant pursuant to this Article, the Company shall indemnify Lender against all losses, claims, damages and liabilities caused by any untrue statement of a material fact contained in any registration statement or prospectus as amended or supplemented, or any preliminary prospectus or any offering circular, or caused by any omission to state a material fact required to be stated or necessary to make the statements not misleading in light of the circumstances under which they are made, except insofar as such losses, claims, damages or liabilities of Lender are caused by any untrue statement or omission based upon information furnished in writing to the Company by Lender expressly for use therein.

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6.10 INDEMNIFICATION OF THE COMPANY.

The obligations of the Company to register any of the Securities shall be subject to the condition that Lender agrees in writing to indemnify the Company, its officers and directors, against all losses, claims, damages and liabilities caused by any untrue statement or omission based upon information furnished in writing by Lender to the Company expressly for use in a registration statement, prospectus or offering circular.

6.11 TERMINATION OF TRANSFER RESTRICTIONS.

The restrictions imposed by this Article on the transfer of the Securities shall terminate as to any portion of the Securities when:

6.11.1 Such portion of the Securities shall have been effectively registered under the 1933 Act and sold by Lender in accordance with such registration; or

6.11.2 Written opinions to the effect that registration is not required under any Federal or State law or regulation of Governmental authority shall have been received from legal counsel for the Company or Lender (and, if from legal counsel for Lender, such opinion is in form and substance satisfactory to the Company). If a favorable opinion is obtained only from Lender's counsel, Lender shall indemnify the Company against all liability or loss it may sustain in connection with the transfer.

Whenever the restrictions imposed by this Article shall terminate as to any Securities, Lender shall be entitled to receive promptly from the Company, without expense to Lender, a new certificate for the Securities, not bearing the restrictive legend set forth in Section 6.2.

6.12 ADDITIONAL REGISTRATION COVENANTS.

So long as any of the Securities remain subject to the restrictions imposed by this Article, the Company shall not without Lender's written consent enter into any agreement or undertaking with any purchaser of the Company's capital stock, Warrant, options or securities convertible into the Company's capital stock to register any of the Securities pursuant to the 1933 Act (except with respect to the warrants, options and convertible securities currently outstanding or the issuance of which is currently contemplated by the Company in each case as described in 2.2 of the Disclosure Schedule, which may contain such an agreement or understanding).

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ARTICLE SEVEN

PRIVATE, RULE 144 SALES

The Company shall file with the Securities and Exchange Commission on a timely basis all current information regarding the Company as shall be necessary to meet the current public information requirements of Rule 144 under the 1933 Act, and shall otherwise fully cooperate with Lender in the private sale or sale under Rule 144 of any of the Securities. In addition, the Company represents and warrants that the information and documents so filed shall not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements, in light of the circumstances under which the statements were made, not misleading, and further agrees to indemnify and hold harmless Lender and each broker, dealer or underwriter (within the meaning of the 1933 Act) acting for it in connection with any offering or sale of Securities from all losses, liabilities and judgments arising out of or resulting from any breach of the foregoing representations or warranty.

ARTICLE EIGHT

DEFAULT

The following acts by the Company shall constitute a default ("Default"):

8.1 FAILURE TO PAY INTEREST OR PRINCIPAL.

If the Company fails to pay any installment of interest or principal due on the Note within 10 days after the due date.

8.2 UNTRUE REPRESENTATION OR WARRANTY.

If any representation or warranty made by the Company to the Lender subsequently proves to have been incomplete or untrue in any material respect as of the Closing Date, or any statement, certificate or data furnished by the Company under this Agreement or its Exhibits proves to have been incomplete or untrue in any respect or misleading under the circumstances in which it was provided as of the date on which the information is stated or certified.

8.3 CONTRACTUAL DEFAULT.

If the Company breaches any part of this Agreement or the Exhibits thereto it shall constitute a Default. The Company acknowledges and agrees that the failure of the Company to comply with the Affirmative and Negative Covenants contained in Articles Three and Four increases the risk to Lender's investment above that contemplated and agreed to by the parties and the Company agrees that any failure to comply with the Affirmative and Negative Covenants is a Default and will be so treated by the Lender.

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Provided, the Company shall have 30 days from the date of any Default to cure the Default if there is a reasonable chance the Default can be cured.

8.4 OTHER OBLIGATIONS.

The Company defaults in any of its obligations to any party other than Lender concerning borrowed money.

ARTICLE NINE

REMEDIES

9.1 LEGAL AND EQUITABLE REMEDIES.

Nothing contained in this Agreement is in any way intended by the parties to waive or modify any legal or equitable remedies the parties may have. Where specific remedies or adjustments to the Investment have been set out in this Agreement and Exhibits, whether legal, equitable, contractual or otherwise, they shall be in addition to the legal and/or equitable remedies the parties shall

have.

9.2 ACCELERATION.

In the event of any Default, Lender may, by notice in writing to the Company, declare the entire principal amount and accrued interest of any of the Company's debt held by Lender immediately due and payable without presentment, demand, protest, notice of protest or other notice of dishonor of any kind, all of which are waived by the Company. This remedy shall not be exclusive of any other remedy in law or equity.

ARTICLE TEN

ADDITIONAL ACTIONS TAKEN BY THE COMPANY

The Company has delivered the following to Lender which are attached as Exhibits:

10.1 OPINION OF COUNSEL FOR THE COMPANY.

An opinion of counsel for the Company, dated the Closing Date and attached as Exhibit 10.1.

10.2 CERTIFIED ARTICLES AND CERTIFICATE OF GOOD STANDING.

A copy of the Company's Articles of Incorporation and a Certificate of Good Standing, both certified to by the Secretary of State of the state in which the Company was incorporated and attached as Exhibit 10.2.

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10.3 CERTIFIED BY-LAWS.

A true and correct copy of the By-Laws of the Company, certified by the secretary of the Company and attached as Exhibit 10.3.

10.4 GOVERNMENTAL AUTHORIZATIONS.

Consents, permits and authorizations from any governmental agency having jurisdiction over the issuance of the Securities necessary for the Company lawfully to issue the Securities. The permits, consents and authorizations are listed in 10.4 of the Disclosure Schedule.

10.5 CONTRACTS.

All written employment contracts; contracts with any officer, director or stockholder or their relatives; all plans pursuant to which benefits are paid to any employee of the Company; and all material contracts with brokers or others for services; and a brief written description of any such agreements that are not in writing, all of which must be satisfactory to Lender and are attached as Exhibit 10.5.

10.6 SBA FORMS.

An executed copy of SBA Form 480, SBA Form 652, Debarment certification, and Statement of Qualification. The SBA forms are attached as Exhibit 10.6.

10.7 SECURITY AGREEMENTS.

The Lender shall be in receipt of the necessary UCC forms to perfect their security interests and the mortgage documents necessary to grant the Lender a second mortgage in all of the real property of the Company (the "Mortgages" and the "Deed of Trust"). The documents are attached as Exhibit 10.7.

10.8 INSURANCE CERTIFICATE.

One or more Certificates of Insurance confirming that the Company has in force fire, extended coverage and liability insurance in amounts satisfactory to the Lender with Lender named as loss payee.

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ARTICLE ELEVEN

GENERAL PROVISIONS

11.1 EXHIBITS.

The attached exhibits are by reference made an integral part of this Agreement:

Exhibit	Title
1.1	Promissory Note
1.2	Security Agreement
1.3	Intercreditor Agreement
1.4	Warrant
2.1	Disclosure Schedule

2.4	Financial Statements
2.5	Use of Proceeds
2.7	Shareholder Information
2.11	Tax Returns
2.13	Authorizations of Shareholders and Directors
3.6.3	Form of Certification
10.1	Opinion of Counsel
10.2	Articles of Incorporation and Certificate of Good Standing
10.3	By-Laws
10.5	Employment and Consulting Contracts
10.6	SBA Forms
10.7	UCC Forms

11.2 APPLICABLE LAW.

This Agreement is to be interpreted in conformity with the Small Business Investment Act of 1958, as amended, and is otherwise governed by the laws of Minnesota. The provisions of this Agreement shall be severable.

11.3 ASSIGNMENT.

This Agreement shall not be assigned by the Company except with the written consent of Lender. Subject to the preceding sentence, the rights and obligations of this Agreement shall be binding upon and inure to the benefit of the parties and their respective successors and assigns.

11.4 HEADINGS.

The headings used in this Agreement are intended for informational purposes only and shall not affect its interpretation.

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Executed this 10th day of September, 1998.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

By: /s/ Edward R. Cameron

Edward R. Cameron
President

MEDALLION CAPITAL, INC.

By: /s/ Dean R. Pickerell

Dean R. Pickerell
Executive Vice President

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THIS NOTE HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED. THIS NOTE HAS BEEN ACQUIRED FOR INVESTMENT AND MAY NOT BE SOLD, OFFERED FOR SALE OR TRANSFERRED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT FOR THIS NOTE UNDER THE ACT OR AN OPINION OF COUNSEL THAT REGISTRATION IS NOT REQUIRED UNDER THE ACT.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTE DUE SEPTEMBER 30, 2005

Amount: \$3,500,000 Date: September 10, 1998
Rate: 13% Maturity: September 30, 2005

FOR VALUE RECEIVED, the undersigned, APPLIANCE RECYCLING CENTERS OF AMERICA, INC., a Minnesota corporation (the "Company"), promises to pay to the order of MEDALLION CAPITAL, INC. ("Lender"), a licensee under the Small Business Investment Act of 1958, at its office at 7831 Glenroy Road, Suite 480, Minneapolis, Minnesota 55439-3132, or such other address as the holder hereof may specify, the principal amount of Three Million Five Hundred Thousand Dollars and No Cents (\$3,500,000) together with interest on the unpaid principal balance from the date hereof until paid at the rate of 13% per annum. Interest calculations shall be based on a 360-day year.

Principal and interest shall be payable monthly based upon the attached amortization schedule. Interest shall be paid at the rate of 19% per annum, so far as the same may be legally enforceable, on any principal and interest overdue for more than 180 days. All payments received will be first applied to unpaid interest with any remainder being applied toward principal reduction.

This Note has been delivered in conjunction with the Loan Agreement dated September 10, 1998, by and between the Company and Lender. Any capitalized terms in this note shall have the same meaning as set forth in the Loan Agreement. The Company's obligations under this Note are secured by a Security Agreement, Deed of Trust and certain Mortgages.

This Note is subject to prepayment in whole or part at any time at the option of the Company. However, prepayment is subject to prepayment penalties as follows: 4% of the prepaid principal amount if repaid prior to September 1, 1999; 3% of the prepaid principal amount if repaid prior to September 1, 2000; 2% of the prepaid principal amount if repaid prior to September 1, 2001. In the case of any payment of less than the total principal amount outstanding on the Note, the payment shall be applied first to the interest owed and then to the principal outstanding.

A Default shall be deemed to have occurred upon the happening of one or more of the following events:

- (a) A failure to make a payment of any installment of principal or interest;
- (b) Any obligation of the Company (other than its obligation hereunder) for the payment of any other debt, except trade payables, is not paid when due or within any applicable grace period;

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- (c) One or more judgments against the Company or attachments against its property, which in the aggregate exceeds \$50,000, or the operation or result of which could be to interfere materially and adversely with the conduct of the business of the Company remains unpaid, unstayed on appeal, undischarged, unbonded and undismissed for a period of 30 days.

Upon the happening of any of the foregoing Defaults, then

- (a) this Note shall become and be immediately due and payable without declaration or other notice to the Company as set forth in Article Nine of the Loan Agreement;
- (b) Payee may exercise any other remedy provided by law, administrative action, or action of any other type whatsoever.
- (c) Payee may exercise any of the remedies set forth in the Security Agreement, including but not limited to, the possession and sale of the Collateral.

The Company agrees, if a Default should occur, to pay the holder's collection costs, including reasonable attorneys' fees and other costs as

permitted by law. The Company waives demand for payment, presentment, notice of dishonor, notice of non-payment, diligence in collecting, grace, notice and protest (other than any notice of acceleration or grace period required or provided for by this Note or Articles Eight or Nine of the Loan Agreement, which the Company does not so waive). The use of any remedy by the holder hereof will not constitute a waiver of the right to use any other remedy provided by law. No release of any security for the principal or interest due under this Note or extension of time for payment of this Note shall release or modify (except as modified in any such extension) the liability of the Company under this Note.

This Note shall be binding upon the Company, its successors and assigns, and shall inure to the benefit of the holder hereof, its successors and assigns.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

/s/ Edward R. Cameron

Edward R. Cameron
President

SECURITY AGREEMENT

APPLIANCE RECYCLING CENTERS OF AMERICA, INC., ("Debtor") and MEDALLION CAPITAL, INC., ("Secured Party") agree:

1. SECURITY INTEREST. Debtor grants Secured Party a security interest in (i) the property described on the attached Schedule 1, (ii) any additions, replacements, accessions and substitutions to or for that property, and (iii) all proceeds of all of the foregoing (collectively "Collateral").

2. OBLIGATIONS SECURED. This security interest is given to secure (i) the payment of the indebtedness described in the Note between the parties dated September 10, 1998 (the "Note") and all extensions and renewals of that indebtedness, (ii) the performance of Debtor under this Security Agreement and (iii) the obligations of Debtor under the Loan Agreement, Warrant, Mortgages and Deed of Trust of even date hereof executed by Debtor in favor of Lender (collectively, "Obligations"), and (iii) the performance of Debtor and all other obligors under the Guaranty and the Stock Pledge Agreements ("Guarantors") attached to the Loan Agreement (collectively "Obligations").

3. OWNERSHIP. Debtor represents and warrants that Debtor owns, and to the extent that the Collateral is to be acquired after the date hereof will own, the Collateral free from encumbrance except any encumbrances shown on the Disclosure Schedule to the Loan Agreement ("Permitted Encumbrances"). Debtor will defend the Collateral against all claims of all persons at any time claiming the Collateral or any interest in the Collateral except Secured Party and holders of Permitted Encumbrances.

4. PERFECTION. Debtor that no Financing Statement covering the Collateral is on file in any public office except those for Permitted Encumbrances. The Collateral is and will remain personal property. Debtor will execute Financing Statements, in a form satisfactory to Secured Party, and will pay the cost of filing Financing Statements and Continuation Statements in all appropriate public offices and will deliver any subordinations or waivers of other liens deemed by Secured Party to be necessary. On demand by Secured Party, but subject to the rights of other secured parties, Debtor will deliver to Secured Party all items of Collateral in which Secured Party' security interest can be perfected by taking possession. The Secured Party will hold those items of Collateral to perfect Secured Party security interest. If those items of Collateral are held by others to perfect another security interest, the others will be considered to be holding those items also as agent for Secured Party. Debtor hereby appoints Secured Party as its attorney-in-fact to do all acts and things which Secured Party may deem necessary

to perfect and to continue perfected the security interest created hereby and to protect and to preserve the Collateral.

5. USE. Until default, Debtor may use the Collateral at Debtor's places of business, in any lawful manner not inconsistent with this Security Agreement, but may not transfer or encumber the Collateral except in the ordinary course of business. A transfer or encumbrance in the ordinary course of business does not include a transfer in partial or total satisfaction of a debt or in bulk. An item of Collateral may not be leased to a third party. An item of collateral with a fair value greater than \$10,000 may not be transferred unless: (i) the item is replaced with another item of equal or greater unencumbered value, or (ii) the proceeds of the transfer are used to reduce the loan balance, or (iii) the proceeds of the transfer are used for a purpose approved in writing by the Lender.

6. PROTECTION. Debtor, at its expense, will keep items of Collateral in good condition and will replace and repair any items of damaged or worn-out Collateral in accordance with good management practices without allowing any lien or security interest to be created on the Collateral because of such replacement or repair. Secured Party may inspect the Collateral at any reasonable time. Debtor will pay when due all taxes and assessments on the Collateral and its use and operation, and all indebtedness secured by encumbrances on the Collateral.

7. INSURANCE. Debtor, at its expense, will insure the items of Collateral with a reliable insurance company against loss or damage by fire, theft and the perils covered by extended coverage in an amount equal to the fair market value of the Collateral with loss payable to Secured Party as its interest may appear, and will deliver to Secured Party on demand evidence of such insurance. If a loss occurs, Secured Party may make the proof of loss and the insurer shall pay the Secured Party alone. Upon destruction of substantially all the destructible items of Collateral, the proceeds will be applied to restoration of the destroyed Collateral. If the Collateral is not restored, the Secured Party may

retain from the insurance proceeds and apply on the Obligations an amount equal to the unpaid balance of the Obligations, whether or not the Obligations are due.

8. COSTS. If Debtor fails to perform any of its duties hereunder, Secured Party may, but shall not be required to, do so on Debtor's behalf. If this Security Agreement is placed in the hands of an attorney for enforcement, Debtor will pay the costs, including the reasonable actual attorneys fees, of the Secured Party incurred in enforcing this Agreement. Any amounts expended by Secured Party in performing Debtor's duties or enforcing this Security Agreement will bear interest at the maximum rate allowed by law but not to exceed 18% per year and will be payable by Debtor to Secured Party on demand.

9. DEFAULT. Debtor will be in default under this Security Agreement and under the Obligations upon the happening of any of the following events:

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(a) Debtor's failure to perform when due any of the terms, covenants or conditions of this Agreement and such default shall continue for a period of 30 days after written notice thereof shall have been given by Secured Party to Debtor; or

(b) The Debtor commits a Default as defined in the Loan Agreement or the Note;

(c) Any representation or warranty made by Debtor herein is false.

10. REMEDIES. Upon Debtor's default Secured Party may, at any time thereafter, declare any monetary Obligation due and payable and all other Obligations immediately performable in accordance with the provisions hereof and of the Loan Agreement, and will have the remedies of Secured Party under the Uniform Commercial Code. Secured Party may take possession of the Collateral with or without judicial process. Secured Party may require Debtor to assemble the Collateral and make it available to Secured Party at a place to be designated by Secured Party which is reasonably convenient to both Party. Secured Party will give Debtor reasonable notice of the time and place of any public sale or of the time after which any private sale or any other intended disposition of the Collateral is to be made. The requirements of reasonable notice shall be met if the notice is mailed, postage prepaid, to Debtor at least 10 days before the time of the sale or disposition.

11. WAIVER. No waiver by Secured Party of any default shall operate as a waiver of any other default or of the same default on a future occasion. The taking of this Security Agreement will not waive or impair any other security Secured Party may have or hereafter acquire for the Obligations, nor will the taking of any additional security waive or impair the rights granted in this Security Agreement. Secured Party may resort to any security it may have in the order it may deem proper, and may apply any payments made on any part of the Obligations to any part of the Obligations, despite any directions of Debtor to the contrary.

12. INFORMATION. Debtor will at all reasonable times allow Secured Party and its agents, employees, attorneys or accountants to examine and inspect the Collateral and to examine, inspect and make extracts from Debtor's books and other records, and to verify under reasonable procedures directly with account debtors or by other methods accounts which are Collateral. Debtor will furnish to Secured Party upon request all documents evidencing any Collateral and any guarantees, security or other information relating thereto.

13. BINDING EFFECT. This Security Agreement will inure to the benefit of, and bind, the Party, their personal representatives, successors and assigns, is specifically enforceable, may be executed in counterpart, is construed under the laws of Minnesota, and may be modified only in writing.

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14. TERMINATION. This Agreement shall terminate upon payment of all obligations owed to Secured Party by the Debtor.

Dated: September 10, 1998.

DEBTOR:

APPLIANCE RECYCLING CENTERS
OF AMERICA, INC.

SECURED PARTY:

MEDALLION CAPITAL, INC.

BY: /s/ Edward R. Cameron

Edward R. Cameron
President

BY: /s/ Dean R. Pickerell

Dean R. Pickerell
Executive Vice President

THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933 (THE "1933 ACT") OR UNDER THE SECURITIES LAWS OF ANY STATE. THEY MAY NOT BE SOLD, TRANSFERRED OR OTHERWISE DISPOSED OF FOR VALUE EXCEPT PURSUANT TO REGISTRATION OR OPERATION OF LAW WITHOUT AN OPINION OF COUNSEL SATISFACTORY TO THE COMPANY THAT SUCH TRANSFER MAY LAWFULLY BE MADE WITHOUT REGISTRATION UNDER THE STATE SECURITIES LAWS AND/OR THE 1933 ACT.

APPLIANCE RECYCLING COMPANIES OF AMERICA, INC.
STOCK PURCHASE WARRANT
700,000 SHARES OF COMMON STOCK

For value received MEDALLION CAPITAL, INC., a Licensee under the Small Business Investment Act of 1958 ("Investor"), or its assigns, is entitled to subscribe for and purchase, upon written notice given any time prior to the latter of September 10, 2007 or two years after the repayment in full of the Note dated September 10, 1998, 700,000 shares of the no par Common Stock, fully paid and nonassessable, of APPLIANCE RECYCLING COMPANIES OF AMERICA, INC., a Minnesota corporation (the "Company"), at the price of \$2.50 per share (the "Warrant Price"), subject to the terms and conditions set forth below.

1. LOAN AGREEMENT. This Warrant is issued pursuant to, and is subject to all of the terms and conditions of the Loan Agreement between the Company and Investor, dated September 10, 1998 (the "Loan Agreement").

2. METHOD OF EXERCISE; PAYMENT; ISSUANCE OF NEW WARRANT; TRANSFER AND EXCHANGE. The holder may exercise the purchase right represented by this Warrant, by surrendering this Warrant, properly endorsed, together with a written request specifying the number of shares to be purchased and the purchase price in cash or by check, at the principal office of the Company. Thereupon, this Warrant shall be deemed exercised and the person exercising this Warrant shall be deemed to have become a holder of record of shares of Common Stock (or other securities or property to which such person is entitled upon such exercise). Certificates for the shares of stock purchased shall be delivered to the holder within 14 days after such exercise. Unless this Warrant has expired, a new Warrant representing the balance of shares not issued under this Warrant shall also be issued to the holder. Subject to the terms and

provisions of this Warrant and Article Six of the Agreement, the holder may transfer this Warrant and its rights, in whole or in part, by surrendering this Warrant at the principal office of the Company, properly endorsed, and paying any necessary governmental tax or transfer Charge. Upon any partial transfer, the Company shall deliver to the holder an appropriate new Warrant certificate. Each holder of this Warrant agrees that when this Warrant is endorsed in blank, it shall be deemed negotiable and the holder may be treated by the Company and all other persons dealing with this Warrant as the absolute owner having the right to transfer of ownership on the books of the Company, any notice to the contrary notwithstanding. However, until the transfer is recorded on the books, the Company may treat the registered holder as the owner. This Warrant is exchangeable at the principal office of the Company for Warrants for the purchase of the same aggregate number of shares of Common Stock, each new Warrant to represent the right to purchase the number of shares of Common Stock, as the holder designates at the time of exchange. All Warrants issued on transfers or exchanges shall be dated the date hereof and shall be identical to this Warrant except as to the number of shares of Common Stock issuable.

3. STOCK FULLY PAID; RESERVATION OF SHARES. The Company covenants that all shares which may be issued upon the exercise by this Warrant will be fully paid and nonassessable and free from all taxes, liens and charges. The Company further covenants that during the time this Warrant may be exercised, the Company will at all times have authorized and reserved the number of shares of its Common Stock issuable upon exercise of this Warrant.

4. ADJUSTMENT OF PURCHASE PRICE AND NUMBER OF SHARES. The number and kind of securities purchasable upon the exercise of this Warrant and the Warrant Price shall be subject to adjustment upon the happening of the following events:

A. CONSOLIDATION, MERGER OR RECLASSIFICATION. If the Company consolidates or merges into any other corporation, or sells, transfers or disposes of all or substantially all the property, assets, business and/or goodwill of the Company to another corporation, or in any manner changes the securities to be purchased upon the exercise of this Warrant, appropriate provisions shall be made in writing to protect the holder of this Warrant against dilution of the holder's interest and rights. A new Warrant evidencing any changes necessary to protect the holder shall be issued by the Board of Directors.

B. SUBDIVISION OR COMBINATION OF SHARES. In case of subdivision of shares, the Warrant price shall be proportionately reduced and the number of shares purchasable upon the exercise of this Warrant proportionately increased. In the case of combination of shares, the Warrant Price shall be proportionately increased and the number of shares purchasable upon the exercise of this Warrant proportionately decreased.

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C. CERTAIN DIVIDENDS AND DISTRIBUTIONS. If the Company takes a record of the holders of its Common Stock for the purpose of:

(i) STOCK DIVIDENDS. Entitling them to receive a dividend payable in, or other distribution of, Common Stock, then the Warrant Price shall be adjusted to that price determined by multiplying the Warrant Price in effect immediately prior to the record date by a fraction; the numerator of which shall be the total number of shares of Common Stock outstanding immediately prior to the record date, and the denominator of which shall be the total number of shares of Common Stock outstanding (including for this purpose fractions of shares which would have been distributed in connection with such dividend or distribution had cash not been paid or script issued in lieu thereof) immediately after the dividend or distribution. The number of shares purchasable upon the exercise of this Warrant shall be adjusted to that number determined by multiplying the number of shares purchasable upon the exercise of this Warrant immediately prior to the record date by a fraction, the numerator of which shall be the Warrant Price adjusted as aforesaid and the denominator of which shall be the Warrant Price immediately prior to the record date; or

(ii) LIQUIDATING DIVIDENDS, ETC. Making a distribution of its assets to the holders of its Common Stock as a dividend in liquidation or partial liquidation or by way of return of capital or other than as a dividend payable out of earnings or surplus legally available for dividends under the laws of the State of Wisconsin, the holders of this Warrant shall, upon its exercise, be entitled to receive, in addition to the number of shares of Common Stock receivable, a sum equal to the amount of assets as would have been payable to them as owners of that number of shares of Common Stock this Warrant represents had this Warrant been exercised immediately prior to the record date for such distribution.

D. ADJUSTMENT FOR DECLINING NET WORTH OF THE COMPANY. If at the time of exercise the net worth (assets minus liabilities as reflected on the Company's last audited balance sheet) has decreased from the net worth that existed on the Closing Date, the Warrant Price shall be equal to the net worth divided by the number of shares of capital stock then outstanding.

E. TREASURY SHARES EXCLUDED. The number of shares of Common Stock at any time outstanding shall not include any shares then directly or indirectly owned by the Company.

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F. OTHER ACTION AFFECTING COMMON STOCK. In the event the Company shall take any action affecting its Common Stock, other than an action described in subsections A through C, which would have a materially adverse effect upon the rights of the holder of this Warrant, the Warrant Price and the number of shares of Common Stock purchasable shall be adjusted in such manner and at such time as the Board of Directors may in good faith determine to be equitable under the circumstances.

5. NOTICE OF ADJUSTMENTS. Whenever any Warrant Price and/or the number of shares of Common Stock purchasable is to be adjusted pursuant to Section 4, the Company shall promptly provide to the holder of this Warrant, a certificate signed by its President and by its Treasurer or Secretary setting forth the event requiring the adjustment, the amount of the adjustment, the method by which such adjustment was calculated (including a description of the basis on which the Company's Board of Directors made any determination), and the Warrant Price or Prices and number of shares of Common Stock purchasable after giving effect to such adjustment.

6. NOTICES OF RECORD DATE, ETC. In the event the Company takes a record of the holders of any class of securities, any capital reorganization, reclassification, recapitalization or transfer of substantially all the assets of the company, consolidation, merger, voluntary or involuntary dissolution,

liquidation or winding-up, the Company shall mail to each holder of a Warrant a notice specifying (i) the date on which any record is to be taken, or (ii) the date on which any reorganization, reclassification, recapitalization, transfer, consolidation, merger, dissolution, liquidation or winding-up is to take place, and the time as of which the holders or record of Common Stock (or other securities) shall be entitled to exchange their shares of Common Stock (or other securities) for securities or other property. The notice shall be mailed at least 15 days prior to the date on the notice. If any right to subscribe for or purchase securities is offered to the holders of Common Stock, the holder of a Warrant shall similarly receive rights with respect to any unexercised shares under the Warrant to the same extent as if the Warrant had been duly exercised.

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7. REGISTRATION RIGHTS. This Warrant shall have all of the registration rights that are contained in Article Six of the Loan Agreement.

Dated and delivered on September 10, 1998.

APPLIANCE RECYCLING COMPANIES OF AMERICA, INC.

By: /s/ Edward R. Cameron

Edward R. Cameron
President

By: /s/ Denis E. Grande

Secretary

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<CURRENT-ASSETS>	135,000
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<CURRENT-LIABILITIES>	3,230,000
<BONDS>	0
<PREFERRED-MANDATORY>	0
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<OTHER-SE>	0
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<SALES>	10,479,000
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<CGS>	6,944,000
<TOTAL-COSTS>	6,944,000
<OTHER-EXPENSES>	(277,000)
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<INTEREST-EXPENSE>	412,000
<INCOME-PRETAX>	(1,684,000)
<INCOME-TAX>	31,000
<INCOME-CONTINUING>	0
<DISCONTINUED>	0
<EXTRAORDINARY>	0
<CHANGES>	0
<NET-INCOME>	(1,715,000)
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